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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

HENRY HARPER, *et al.*,
Petitioners,

v.

VIRGINIA DEPARTMENT OF TAXATION,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Virginia

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BRIEF *AMICI CURIAE* ON BEHALF OF THE ARIZONA AND WISCONSIN STATE FEDERATIONS OF CHAPTERS OF THE NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES IN SUPPORT OF PETITIONERS

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QUESTIONS PRESENTED

1. Whether this Court's decision in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989), may under any circumstance be "applied" nonretroactively so as to defeat federal retirees' entitlement to refunds of unconstitutional state taxes imposed upon their federal annuities.

2. Whether the doctrine of intergovernmental tax immunity and 4 U.S.C. § 111 prohibit a state from taxing pensions of military retirees while exempting from taxation the pensions of its own retired employees.

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Pursuant to Rule 37.2 of the Rules of this Court, the parties have consented to the filing of this brief.

INTEREST OF *AMICI*

Amici are the Arizona and Wisconsin State Federation of Chapters of the National Association of Retired Federal Employees ("NARFE"). NARFE is a nonprofit, incorporated association having its principal place of business in Washington, D.C. From its original fourteen charter members, NARFE has grown to a membership now exceeding 500,000 federal annuitants (retirees and survivors) living throughout the fifty states, Puerto Rico, the Canal Zone, the Republic of the Philippines, and

various foreign countries. NARFE has been a major advocate in maintaining the integrity of the federal government's civilian retirement systems and has been directly involved, through lobbying and related activities, in all legislative and executive changes in these systems over the past six decades.

NARFE has concerned itself with issues affecting the aged and aging, and in particular those issues that affect federal annuitants. NARFE's goal is to identify issues of particular importance to federal annuitants, to inform them, through its Newsletter and the state and local chapter network, of these issues, and to act upon these issues to further the members' common goals. NARFE also assists federal annuitants in obtaining benefits to which they may be entitled under the retirement laws by interacting with various federal agencies and private entities on such matters as federal annuities and health and life insurance benefits. The Arizona and Wisconsin State Federations of Chapters are involved with implementing NARFE's policies in the States of Arizona and Wisconsin, respectively, and coordinating local activities.

The State of Virginia and at least twenty-two other states taxed the federal retirement benefits of federal annuitants while exempting from state taxation the retirement benefits of state annuitants. This disparate tax treatment is in violation of 4 U.S.C. § 111 and the constitutional doctrine of intergovernmental tax immunity.

The question presented in this case—whether the refunds of state income tax imposed in violation of 4 U.S.C. § 111 may be denied through a prospective-only application of *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989)—is vitally important to *amici*. If a prospective only application of *Davis* is applied, these federal annuitants will suffer economic harm. Thus, *amici* have a compelling and vital interest in the proper resolution of the questions presented.

REASONS FOR GRANTING THE WRIT

This case raises important questions regarding the propriety of states retaining taxes imposed and collected from their citizens in violation of the Constitution of the United States and 4 U.S.C. § 111. *Amici* ask that this Court grant certiorari to reverse the decision of the Supreme Court of Virginia. The Court below presumed that it had the authority to decree that a decision striking down state taxes on constitutional grounds may be applied prospectively only. *Amici* contend that the conclusion of the court below is contrary to the plain holding of this Court in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). Upon remand from this Court, the Virginia Supreme Court held that this Court did not apply the rule retroactively to Mr. Davis, noting that the "Court made no such ruling in *Davis*." *Harper v. Virginia Dep't of Taxation*, No. 900792 (Nov. 8, 1991).[1]

In *Davis*, the Court invalidated Michigan's discriminatory tax scheme as in effect during the tax years 1979 through 1984 and applied its decision to the litigants before it stating that "to the extent appellant has paid taxes pursuant to this invalid tax scheme, he is entitled to a refund." 489 U.S. at 817 (citing *Iowa-Des Moines Bank v. Bennett*, 284 U.S. 239, 247 (1931)).[2] Having accorded Mr. Davis the benefit of the decision in *Davis*, it necessarily follows that the holding must be applied "to all others not barred by procedural requirements or res judicata." *James B. Beam Distilling Co. v. Georgia*, 111 S. Ct. 2439, 2448 (1991).

However, even assuming *amici* misread this Court's decision in *Davis* and its judgment in *Beam*, *amici* respectfully submit that the result reached by the Supreme Court

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[1] *See* Petition at 4a.

[2] The very issue resolved in *Davis* was that "federal retirement benefits [for the years 1979 through 1984] were 'not legally taxable under the Michigan Income Tax Law.'" *Davis*, 489 U.S. at 806-07.

of Virginia was, nonetheless, clearly erroneous. In view of the important federal interests implicated by this case, review by this Court is warranted to ensure that the encroachment upon federal power by the court below is not allowed.

I. A STATE COURT DOES NOT HAVE THE POWER TO CHANGE THE EFFECTIVE DATE OF A CONGRESSIONAL ENACTMENT

In *Davis v. Michigan Dep't of the Treasury*, 489 U.S. 803 (1989), this Court construed the "plain language" of 4 U.S.C. § 111 and concluded that the "statute leaves no room for doubt" that federal retirement benefits "are subject to § 111." *Id.* at 808-09. However, in the decision below, the Supreme Court of Virginia, motivated solely by parochial concerns and ostensibly relying on its view of the prospectivity doctrine, apparently believed that it had the unfettered power to change the effective date of this unambiguous federal statute. The practical consequence of its decision, if permitted to stand, is that 4 U.S.C. § 111 is effective for all tax years after *1988* in Virginia, whereas the statute has been effective throughout the rest of the country since January 1, 1939. *See* Public Salary Tax Act of 1939, Ch. 59, § 4. (App. A at 1a). *See also Meredith v. State Tax Commission*, 163 Or. 305, 312-13, 96 P.2d 1082 (1939) (recognizing that the effective date of the Public Salary Tax Act as enacted by Congress is controlling.).

Within the last two weeks, a trial court in the State of Arizona has been persuaded to ignore clearly established state refund statutes and long-standing administrative refund practices and ruled, in reliance upon the decision below, that for years prior to *1991* a state tax scheme which discriminated in favor of current state employees and against current federal employees in violation of 4 U.S.C. § 111 was not "unconstitutional." *See Kerr v. Waddell*, TX 89-01153 (Arizona Tax Court, Nov.

26, 1991). In addition, in virtually all of the states where *Davis* litigation is not yet final, state appellate courts are being urged to adopt the decision below as dispositive constitutional law.[3]

The position urged by the defendants below and reaffirmed by the Supreme Court of Virginia upon remand from this Court is unprecedented. In fact, it is fundamentally inconsistent with settled notions of federalism and state courts' obligations under the Supremacy Clause. Moreover, given the hysteria created by the exaggerated claims of the fiscal burden advanced by the Attorneys General of several states, the jurisprudence of several states has already been infected by the adoption of the rational of this decision.[4]

The decision below is irreconcilable with this Court's landmark decision of *M'Culloch v. Maryland*, 17 U.S. 415 (1819). The Supreme Court of Virginia does not have the "power" to substitute its determination for that of Congress:

> [T]he States have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the general government.

Id. at 439. A unanimous Court recently reaffirmed this principle in the context of 42 U.S.C. § 1983, noting that:

> The policy of the Federal Act was to be considered 'the prevailing policy in every state' which the state court could not refuse to enforce 'because of concep-

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[3] *See, e.g.*, State defendants' letter brief of November 14, 1991 in *Duffy v. Wheeler*, 148 Misc. 2d 459, 555 N.Y.S.2d 543 (N.Y. 1990), *appeal docketed*, No. 90-07800 (2d Dept. 1991).

[4] *See, e.g., Sheehy v. Department of Revenue*, No. 90-450, 1991 WL 238253 (Mont. Nov. 14, 1991); *Swanson v. North Carolina*, 407 S.E.2d 791 (N.C. 1991), *aff'd on reh'g*, No. 64PA91-Wake (Dec. 6, 1991).

> tions of impolicy or want of wisdom on the part of Congress in having called into play its lawful powers.'

Howlett v. Rose, 110 S. Ct. 2430, 2442 (1990) (citations omitted). And again last term, the Court, in the context of applying another unambiguous statute, instructed that " 'the sole function of the court is to enforce it [the statute] according to its terms.' " *West Virginia Univ. Hosp., Inc. v. Casey*, 111 S. Ct. 1138, 1147 (1991) (citations omitted).

Indeed, if the decision below were to stand, the resulting anomaly in the law would be breathtaking. In *Fleming v. Fleming*, 264 U.S. 29 (1924), this Court ruled with respect to a state court's construction of a state statute that:

> The effect of the subsequent decisions is not to make a new law, but only to hold that the law always meant what the court now says it means. The court has power to construe a legislative act, but it has no power by change in construction to date its passage as a law from the time of the later decision.

Id. at 31-32. Under this settled view, the Supreme Court of Virginia would be powerless to change the effective dates of legislation of its own legislature, but yet, motivated by uniquely parochial interests, would have the power, within Virginia, to change the effective dates of legislation passed by Congress. However, as this Court has ruled:

> The laws of the United States are laws in the several States, and just as much binding on the citizens and courts thereof as the State laws are.

Claflin v. Houseman, 93 U.S. 130, 136 (1876).

In a context analogous to the issues presented here, this Court has previously held that it does not possess the power which the Supreme Court of Virginia exercised below. In *Aloha Airlines, Inc. v. Director of Taxation*, 464 U.S. 7 (1983), this Court invalidated a Hawaii stat-

ute that imposed a tax on gross income of airlines operating within the state because it had been pre-empted by Congress.[5] In so holding, this Court noted that it was bound by the determination of Congress:

> We acknowledge that our interpretation of § 1513(a) may result in the disruption of state systems of taxation; we are, however *bound* by the plain language of the statute.

Id. at 14 n.10 (emphasis added).[6]

The important issue of federalism decided by the court below presents a significant danger, the impact of which transcends the interests of federal retirees of Virginia and the hundreds of thousands of federal retirees whose rights under *Davis* are currently the subject of ongoing litigation in approximately eighteen states. The real danger that the holding below presents is that it will be readily extended by Virginia and other states to limit states' obligations to comply with Congressional enactments involving the general welfare. However, no court possesses the "veto" power which the Supreme Court of Virginia exercised below. As this Court held in *Tennessee Valley Auth. v. Hill*, 437 U.S. 153 (1978):

> Once the meaning of an enactment is discerned and its constitutionality determined, the judicial process

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[5] Prior pronouncements of this Court in the context of federal legislation involving a conditional waiver of intergovernmental tax immunity indicate that, absent a strict adherence to the requirements of such legislation, state tax enactments will be invalidated. *See, e.g., Chase Manhattan Bank, N.A. v. Finance Admin.*, 440 U.S. 447 (1979).

[6] *See also Commissioner of Immigration v. Gottlieb*, 265 U.S. 310, 312 (1924) ("The case, as the evidence shows, is one of peculiar and distressing hardship, and it is not unnatural that any appropriate canon of construction should be laid hold of to justify a conclusion favorable to respondents. But if the plain words of the statute are against such a conclusion, leaving no room for construction, the courts have no choice but to follow it, without regard to the consequences.").

> comes to an end. We do not sit as a committee of review, nor are we vested with the power of veto.

Id. at 194-95.

Amici respectfully submit that this Court's carefully articulated retroactivity decisions of the last two terms have no application, in the first instance, in a case involving an unambiguous statute, the overall meaning of which is "unmistakable." *Davis*, 489 U.S. at 810. It was error for the court below, under the guise of the prospectivity doctrine, to change the considered decision of Congress, which carefully weighed the equities in establishing the January 1, 1939 effective date of 4 U.S.C. § 111. *See* Public Salary Tax Act of 1939, Title I, § 4; Title II, § 201 (App. A at 1a-2a). Consistent with the command of the Supremacy Clause and *M'Culloch v. Maryland*, a grant of the petition for writ of certiorari in this case will permit this Court to resolve the uncertainty created in the law of the several states as the result of the decision below.

II. ALTERNATIVELY, ASSUMING THIS COURT DETERMINES THAT THE PLURALITY APPROACH OF *AMERICAN TRUCKING ASS'N* MAY BE APPLIED TO A CONGRESSIONAL ENACTMENT, A DETERMINATION OF PROSPECTIVITY MAY ONLY BE UPHELD UPON A MEANINGFUL ANALYSIS OF THE SECOND AND THIRD PRONGS OF *CHEVRON*

The plurality observed in *American Trucking Ass'n v. Smith*, 110 S. Ct. 2323 (1990), that the "policy concerns involved" in a decision delineating the scope of liability under a federal statute "are quite distinct" and provide little guidance for determining the fairest way to apply the Court's decisions in the context of the dormant Commerce Clause doctrine. *Amici* respectfully submit that the application of the prospectivity test reflected in the plurality decision of *American Trucking Ass'n* is particularly inappropriate to a case such as this where Congress has made the express policy decision as to the statute's effective date. However, assuming this Court is persuaded that it should apply the *American Trucking Ass'n* plurality test and assuming further that the threshold test is somehow deemed satisfied, this Court should determine the appropriate parameters for prongs two and three of that test when applied in the context of a state personal income tax where the interests of the United States, as well as elderly citizens, are implicated.[7]

Setting aside the issue of whether the first prong was correctly determined, the court below summarily concluded that, because the state statute at issue was repealed prospectively, this prong had been satisfied. (Pet. App. C at 12a).[8] This summary observation can hardly be deemed adequate.

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[7] As cogently pointed out in the original petition in this case, the determination of the Supreme Court of Virginia on the first prong appears to be nothing more than a bald conclusion. *See* Petition No. 90-1685 at 9-13. A review of this Court's opinion in *Davis* clearly reflects that the party who sought to overrule "clear past precedent" was not the taxpayer but the Michigan Department of the Treasury. *Davis*, 489 U.S. at 814-15. In addition, under this Court's reasoning in *Ashland Oil, Inc. v. Caryl*, 110 S. Ct. 3202 (1990) and *National Mines Corp. v. Caryl*, 110 S. Ct. 3205 (1990), even if *Davis* is subject to the prospectivity test, it still should be applied retroactively. *See South Carolina v. Baker*, 485 U.S. 505, 520 n.10 (1988) (the law has always been that Congress has the power to enact statutes immunizing those with whom it deals from state taxation even if the doctrine would not otherwise confer immunity.). *See also* note 8, *infra*.

[8] In addressing the first prong, it apparently was of no moment to the court below that Congress specifically provided in the Public Salary Tax Act of 1939 that the Act was to be construed by reference to the Internal Revenue Code. *See* Sec. 206. (App. A at 4a). Under the Code, it has been clearly established for almost 70 years that pensions for government service are governed by the doctrine of intergovernmental tax immunity. *See* I.T. 1607, II-1 C.B. 71 (1923) ("Inasmuch as salaries and wages received by officers and employees of the State are exempt from taxation . . . it is held

This Court should take the opportunity to frame the duty of a court to engage in a meaningful inquiry under this prong. Had such an inquiry been undertaken in this case, the court below would have been forced to conclude that the purpose of the rule could be furthered only by retrospective operation. The court's failure to apply *Davis* retroactively, in fact, frustrates the operation of the rule.

In *Trinityfarm Constr. Co. v. Grosjean*, 291 U.S. 466 (1934), the Court observed that:

> [The] application [of the intergovernmental tax immunity doctrine] does not depend upon the amount of exaction, the weight of the burden, or the extent of the resulting interference with sovereign independence. Where it applies, the principle is an absolute one wholly unaffected by matters or distinctions of degree . . . . Its right application is essential to the orderly conduct of the national and state governments and the attainment of justice as between them.

Id. at 471.

For over four decades, Virginia reduced its employment costs at the expense of the federal treasury. *See Davis*, 489 U.S. at 815 n.4. In addition, during that same period of time, it misappropriated substantial federal revenues by virtue of the discriminatory tax imposed upon federal retirees. These state exactions were deducted

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that the retirement allowance given employees of the State of New York under the New York State Employees' Retirement System represents compensation for past services rendered and is exempt from taxation."); I.T. 2669, XII-1 C.B. 68 (1933) (pensions paid to person who rendered services as an officer or employee of a State or political subdivision thereof "represent compensation paid for past services rendered, and since the compensation in such cases was exempt from Federal income tax the pensions are also exempt from Federal income tax."); I.T. 3364, 1940-1 C.B. 19 (holding that municipal pensions were not taxable prior to the effective date of the Public Salary Tax Act, but were taxable thereafter.). *See also* note 9, *infra*.

by numerous federal retirees under 26 U.S.C. § 164, directly reducing federal income tax collections for each of those years. (App. B at 6a).[9] Refunds of these taxes now will enable the federal government to recover part of the federal revenues misappropriated by Virginia in past years. Under the Tax Benefit Doctrine and section 111 of the Internal Revenue Code, any refund ordered will be subject to federal tax in the year received. *Id.* Consequently, the refusal of the Supreme Court of Virginia to order refunds has actually resulted in a new violation of 4 U.S.C. § 111.

With respect to the third prong, the court's analysis is almost nonexistent. (*See* Pet. App. C at 12a-14a). Its analysis consisted solely of the alleged financial burden upon the state. The relevant equities are far broader in this case and generally, in the context of a personal income tax case, should differ significantly from those weighed under a Commerce Clause challenge.

First, the court below made no effort to quantify the windfall that Virgina received during the forty-plus years this unlawful scheme was in effect.[10] Common sense

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[9] In startling contrast to the State of Virginia, during this same period, the Internal Revenue Service has consistently adhered to the doctrine of intergovernmental tax immunity and the provisions of the Public Salary Tax Act of 1939 by recognizing that the part of *current* pension payments received by state and local retirees, which is attributable to employer contributions for years prior to 1939, is exempt from the federal income tax in accordance with the requirements of the Act. *See* Rev. Rul. 56-82, 1956-1 C.B. 59; Rev. Rul. 57-75, 1957-1 C.B. 28.

[10] Indeed, it is surprising that the State of Virginia even urged that the equities favored no relief. For its size and contribution to the federal fisc, Virginia's economy for years has been the beneficiary of a generous federal government. Recent statistical data reflect that in fiscal year 1989, the Department of Defense, alone, spent over $15 billion in the state. *See* Department of Defense ATLAS/DATA ABSTRACT FOR THE UNITED STATES AND SELECTED AREAS—FY 1989. (App. C at 9a).

suggests that the amount of taxes exacted for years before 1985 exceeds by several times any present refund obligation. Second, Virginia did not hesitate to accept that part of the Public Salary Tax Act of 1939 which benefitted its parochial interests. Under Title II of the Act, Virginia's retirees, as well as its then current employees, enjoyed total immunity from the federal income tax for all years prior to 1939. *See* Public Salary Tax Act of 1939, Ch. 59, Title II. (App. A at 3a). Having accepted the benefits of the Act, equity compels that Virginia now accept its burden.

Most significantly, the court failed to analyze the equities and reliance interests of its federal retirees, many of whom are elderly. Unlike *American Trucking Ass'n*, the taxpayers here are not sophisticated multi-state business enterprises. They are average, law-abiding citizens who complied with the mandates of the Virginia law. For purposes of weighing the equities, they should not now be penalized by Virginia for complying with its laws. Moreover, it is totally inappropriate for a court to penalize an elderly citizen because that citizen could not afford to challenge that which the State should have known was, at best, suspect.[11] With respect to Virginia's tax collections

[11] As noted in the now final decision of Judge Hererra in the *Davis*-related case of *Burns v. Shaw*, No. 89-1314(c) (N.M. Santa Fe County, Apr. 5, 1990):

> [T]he State . . . argues that the decision in *Davis* was not foreshadowed because it has gone unchallenged. Such an analysis begs the question. The State . . . cannot sit by and wait until a law is challenged without an independent analysis of whether or not it is legal. What rationale did the State have for treating Federal retirees and State retirees differently? . . . The operative question should not be whether the statutory scheme was challenged, relying on actions by some unidentified parties, but whether it was reasonable for the State . . . to assume that it was constitutionally [sic] permissible to treat State retirees differently from Federal retirees. Such a distinction defies logic and could have been anticipated by the State . . . even without intervention from the United States Supreme Court. An *objective* analysis would have led the State . . . to conclude that the distinction was suspect and incorrect.

Id. slip. op. at 4 (emphasis added).

after this Court's announcement of *Davis*, there are no equities which would justify the retention of these taxes.

The Supreme Court of Virginia's analysis of the equities also manifests a lack of understanding of the uniqueness of the personal income tax refund right. Most states have long since adopted the federal standard of equity and conscience which favors the taxpayer.[12] This standard has its genesis in several of this Court's decisions involving federal taxation. As noted in *George Moore Ice Cream Co. v. Rose*, 289 U.S. 373 (1933), "[a] high-minded government renounced an advantage that was felt to be ignoble, and set up a new standard of equity and conscience." *Id.* at 379. This standard expressly rejects such "ignoble" concepts as payment under protest, the power of the sovereign to retain invalid exactions, and the power to qualify the refund right by prospective decisions. Moreover, the federal refund right is conditioned or limited *solely* by the statute of limitations. In *Jones v. Liberty Glass Co.*, 332 U.S. 524 (1947), this Court said:

> [W]e read the word 'overpayment' in its usual sense, as meaning any payment in excess of that which is properly due. Such an excess payment may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment.

[12] *See, e.g., Hackman v. Director of Revenue*, 771 S.W.2d 77 (Mo. 1989) (banc), *cert. denied*, 493 U.S. 1019 (1990); New York Tax Law §§ 607(a), 687(a) (McKinney's 1986 & Supp. 1990) (App. D at 10a). *See also Kuhn v. State*, 817 P.2d 101 (Colo. 1991).

Id. at 531. This standard is based on sound considerations of public policy and seeks as its end to promote compliance with the income tax system.[13]

Indeed, Virginia's scheme of personal income taxation "piggybacks" on the federal scheme of taxation. Virginia has adopted the provisions of the Internal Revenue Code as the substantive state tax law, subject to limited statutory modifications. *See* Code §§ 58.1-301, 58.1-322 (App. F at 22a). In addition, the state refund right is not conditioned by a payment under protest provision and merely requires the timely filing of a refund claim. *See* Code §§ 58.1-1823, 58.1-1824; Reg. Sec. 630-2-499 D. (App. F at 22a). Virginia's scheme of personal income taxation expressly grants its citizens the right to claim and receive refunds of Virginia income taxes, which are attributable to intervening developments under the Internal Revenue Code. *Id.* Moreover, the period within which a refund may be claimed provides for an extended period of limitations where there is a change in the taxpayer's underlying federal income tax liability. *Id.*

Contrary to the decision below, the reliance interests of Virginia are meager. By virtue of its piggyback scheme of taxation, Virginia has expressly rendered its tax scheme subject to a host of unanticipated events, including unforeseen and unanticipated developments in the administrative rules of the Internal Revenue Service, enactments of Congress and federal decisional law. *See* Code § 58.1-301. Stated another way, the unforesen is an integral and anticipated element of the Virginia personal income tax law. Consequently, the contentions of the respondent below that the state refund right could be denied in this case because the refund liability was unforeseen is without merit.

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[13] *See* REPORT AND RECOMMENDATIONS ON TAXPAYER COMPLIANCE, American Bar Association Commission on Taxpayer Compliance, July, 1989, 41 Tax Lawyer 329, 353 (1988) ("Strict and unreasonable enforcement can, in fact, contribute to undermining the policy goals which the rules are designed to enforce.").

Moreover, the decision of the court below to qualify the petitioners' refund rights under state law raises an independent constitutional ground for invalidating the decision. Here, the petitioners, who are seeking to enforce a constitutional right, are being required to satisfy and defeat the condition of the prospectivity defense, a condition not otherwise imposed on other Virginia taxpayers.[14]

The petitioners' refund right cannot be subject to a defense based on the origin of the claim—the Constitution, when other Virginia income taxpayers' refund rights based on state law are not subject to or qualified by the defense. *See McKnett v. St. Louis & S.F. Ry.*, 292 U.S. 230, 234 (1934) ("A state may not discriminate against rights arising under federal laws.").

Refunds in cases such as this one would actually be in the best interest of the state because they would restore taxpayer confidence in the integrity and fairness of the personal income tax law of Virginia and the courts which are called upon to cure the abuses of those who are entrusted to enforce it. It is now a matter of common knowledge that honest citizens have less confidence in the fairness of the system and have been subject to widespread abuse by state tax collectors. This problem has become so significant that the organized bar has called for immediate reform by each of the states in light of its findings that:

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[14] For example, another taxpayer may challenge an item of federal adjusted gross income and by final judgment or settlement establish a new principle of law under the Internal Revenue Code. *See, e.g., Cottage Sav. Ass'n v. Commissioner*, 111 S. Ct. 1503 (1991). At the federal level, the taxpayer is entitled to a refund "whatever the reason." *Jones*, 332 U.S. at 531. That same taxpayer would then automatically be entitled to a refund of the Virginia tax attributable to that piggybacked item of income and, as a matter of Virginia law, could not be subject to the prospectivity defense, even if all the tests of the prospectivity defense were otherwise satisfied. *See* Reg. Sec. 630-2-499 D. Indeed, such a taxpayer would receive the benefit of an extended statute of limitations to make the claim. *Id.*

> For many years taxpayers have objected to perceived unfair and arbitrary treatment in compliance, assessment, and appeals of state and local taxes. When taxpayers perceive such treatment, voluntary compliance is seriously threatened. Addressing these concerns should increase respect for the tax system and improve the level of voluntary compliance.

Section of Taxation REPORT TO HOUSE OF DELEGATES, August, 1990 at 2. (App. E at 12a.) If Virginia is permitted to breach its obligation to its citizens to pay refunds, all citizens of Virginia will ultimately pay a higher price as the result of increasing noncompliance.

This Court should take the opportunity in this case to frame the scope of the inquiry necessary to sustain a finding of prospective application only. Indeed, if prospective decision making is ever permissible, at a minimum, it should require an affirmative showing of the taxing authority that under its settled practice in the context of the particular tax involved its conduct in denying a refund has been manifestly reasonable.

CONCLUSION

A state court simply does not have the power under the guise of the prospectivity doctrine to change the effective date of a congressional enactment. The decision below clearly conflicts with this settled principle of federalism. In view of the adverse impact that the decision below has already had on the decisions of other state courts and in view of the clarity of the decisional law regarding the obligations of courts to enforce unambiguous statutes according to their terms, *amici* respectfully urge that the Court grant the Petition and reverse the decision of the Supreme Court of Virginia. *See, e.g., Chase Manhattan Bank, N.A. v. Finance Admin.*, 440 U.S. 447 (1979).

Respectfully submitted,

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December 16, 1991

APPENDICES

APPENDIX A

PUBLIC SALARY TAX ACT OF 1939

AN ACT

Relating to the taxation of the compensation of public officers and employees.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Public Salary Tax Act of 1939".

TITLE I

SECTION 1. Section 22(a) of the Internal Revenue Code (relating to the definition of "gross income") is amended by inserting after the words "compensation for personal service" the following: ("including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing)".

SEC. 2. Section 116(b) of the Internal Revenue Code (exempting compensation of teachers in Alaska and Hawaii from income tax) is repealed.

SEC. 3. Section 22(a) of the Internal Revenue Code is amended by adding at the end thereof a new sentence to read as follows: "In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income".

SEC. 4. The United States hereby consents to the taxation of compensation, received after December 31, 1938, for personal service as an officer or employee of the United States, any Territory or possession of political subdivision thereof, the District of Columbia, or any agency or

instrumentality of any one or more of the foregoing, by any duly constituted taxing authority having jurisdiction to tax such compensation, if such taxation does not discriminate against such officer or employee because of the source of such compensation.

TITLE II

SEC. 201. Any amount of income tax (including interest, additions-to-tax, and additional amounts) for any taxable year beginning prior to January 1, 1938, to the extent attributable to compensation for personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing—

(a) shall not be assessed, and no proceeding in court for the collection thereof shall be begun or prosecuted (unless pursuant to an assessment made prior to January 1, 1939);

(b) if assessed after December 31, 1938, the assessment shall be abated, and any amount collected in pursuance of such assessment shall be credited or refunded in the same manner as in the case of an income tax erroneously collected; and

(c) shall, if collected on or before the date of the enactment of this Act, be credited or refunded in the same manner as in the case of an income tax erroneously collected, in the following cases—

(1) Where a claim for refund of such amount was filed before January 19, 1939, and was not disallowed on or before the date of the enactment of this Act;

(2) Where such claim was so filed but has been disallowed and the time for beginning suit with respect thereto has not expired on the date of the enactment of this Act;

(3) Where a suit for the recovery of such amount is pending on the date of the enactment of this Act; and

(4) Where a petition to the Board of Tax Appeals has been filed with respect to such amount and the Board's decision has not become final before the date of the enactment of this Act.

SEC. 202. In the case of any taxable year beginning after December 31, 1937, and before January 1, 1939, compensation for personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, shall not be included in the gross income of any individual under Title I of the Revenue Act of 1938 and shall be exempt from taxation under such title, if such individual either—

(a) did not include in his return for a taxable year beginning after December 31, 1936, and before January 1, 1938, any amount as compensation for personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing; or

(b) did include any such amount in such return, but is entitled under section 201 of this Act to have the tax attributable thereto credited or refunded.

SEC. 203. Any amount of income tax (including interest, additions to tax, and additional amounts) collected on, before, or after the date of the enactment of this Act for any taxable year beginning prior to January 1, 1939, to the extent attributable to compensation for personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, shall be credited or refunded in the same manner as in the case of an income tax erroneously collected, if claim for refund with respect thereto is filed after January 18, 1939, and

the Commissioner of Internal Revenue, under regulations prescribed by him with the approval of the Secretary of the Treasury, finds that disallowance of such claim would result in the application of the doctrines in the cases of Helvering against Therrell (303 U.S. 218), Helvering against Gerhardt (304 U.S. 405), and Graves et al. against New York ex rel O'Keefe, decided March 27, 1939, extending the classes of officers and employees subject to Federal taxation.

SEC. 204. Neither section 201 nor section 203 shall apply in any case where the claim for refund, or the institution of the suit, or the filing of the petition with the Board was, at the time filed or begun, barred by the statute of limitations properly applicable thereto.

SEC. 205. Compensation shall not be considered as compensation within the meaning of sections 201, 202, and 203 to the extent that it is paid directly or indirectly by the United States or any agency or instrumentality thereof.

SEC. 206. The terms used in this Act shall have the same meaning as when used in Chapter 1 of the Internal Revenue Code.

SEC. 207. No collection of any tax (including interest, additions to tax, and penalties) imposed by any State, Territory, possession, or local taxing authority on the compensation, received before January 1, 1939, for personal service as an officer or employee of the United States or any agency or instrumentality thereof which is exempt from Federal income taxation and, if a corporate agency or instrumentality, is one (a) a majority of the stock of which is owned by or on behalf of the United States, or (b) the power to appoint or select a majority of the board of directors of which is exercisable by or on behalf of the United States, shall be made after the date of the enactment of this Act.

SEC. 208. This title shall not apply with respect to any officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, after the Secretary of the Treasury has determined and proclaimed that it is the policy of such State to collect from any individual any tax, interest, additions to tax, or penalties, on account of compensation received by such individual prior to January 1, 1939, for personal service as an officer or employee of the United States or any agency or instrumentality thereof. In making such determination the Secretary of the Treasury shall disregard the taxation of officers and employees of any corporate agency or instrumentality which is not exempt from Federal income taxation, or which if so exempt is one (a) a majority of the stock of which is not owned by or on behalf of the United States and (b) the power to appoint or select a majority of the board of directors of which is not exercisable by or on behalf of the United States.

SEC. 209. In the case of the judges of the Supreme Court, and of the inferior courts of the United States created under article III of the Constitution, who took office on or before June 6, 1932, the compensation received as such shall not be subject to income tax under the Revenue Act of 1938 or any prior revenue Act.

SEC. 210. For the purposes of this Act, the term "officer or employee" includes a member of a legislative body and a judge or officer of a court.

SEC. 211. If either title of this Act, or the application thereof to any person or circumstances, is held invalid, the other title of the Act shall not be affected thereby.

Approved, April 12, 1939.

APPENDIX B

EXCERPTS FROM THE INTERNAL REVENUE CODE

[Sec. 111]

SEC. 111. RECOVERY OF TAX BENEFIT ITEMS.

[Sec. 111(a)]

(a) DEDUCTIONS.—Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.

[Sec. 164]

SEC. 164. TAXES.

[Sec. 164(a)]

(a) GENERAL RULE.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) The GST tax imposed on income distributions.

(5) The environmental tax imposed by section 59A.

In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for

production of income). Notwithstanding the preceding sentence, any tax (not described in the first sentence of this subsection) which is paid or accrued by the taxpayer in connection with an acquisition or disposition of property shall be treated as part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition.

APPENDIX C

EXCERPT FROM DoD ATLAS—FY 1989

DoD ESTIMATED PAYROLL AND PRIME CONTRACTS BY STATE

(THOUSANDS OF DOLLARS)
FISCAL YEAR 1989

State	Civilian Pay	Military Active Duty Pay	Reserve & National Guard Pay	Retired Military Pay	Total Compensation	Civil Functions Contracts	Military Functions Contracts	Total Contracts
Alabama	789,524	588,907	222,248	498,323	2,099,002	86,857	1,305,531	1,392,388
Alaska	193,392	567,974	24,774	64,562	850,702	17,458	522,337	539,795
Arizona	304,621	589,779	71,806	527,678	1,493,684	11,368	2,835,519	2,846,887
Arkansas	136,907	199,024	71,951	255,818	663,700	38,261	331,331	369,592
California	4,012,634	6,516,801	431,083	2,952,123	13,912,641	60,595	23,064,102	23,124,697
Colorado	363,176	1,008,837	114,248	563,590	2,039,851	6,899	2,921,402	2,928,301
Connecticut	146,690	287,806	49,112	135,908	637,516	1,269	6,081,021	6,082,290
Delaware	47,157	96,153	27,281	64,451	235,042	12,283	158,753	171,036
District of Columbia	564,469	386,633	98,044	66,730	1,115,876	6,652	1,229,312	1,235,964
Florida	1,030,474	2,215,970	153,749	2,092,292	5,492,485	28,356	4,424,027	4,452,383
Georgia	1,030,707	1,731,308	271,133	740,461	3,773,609	34,357	1,829,823	1,864,180
Hawaii	639,481	1,362,357	40,274	191,892	2,234,004	8,018	570,715	578,733
Idaho	34,934	112,486	39,122	98,955	285,497	667	74,122	74,789
Illinois	560,533	729,495	166,545	308,140	1,764,713	30,814	1,218,287	1,249,101
Indiana	456,254	141,030	184,216	185,580	966,580	9,714	1,753,363	1,763,077
Iowa	37,837	9,297	57,692	81,894	186,720	7,897	418,013	452,910
Kansas	180,175	623,131	188,094	192,962	1,162,362	6,754	948,213	954,967
Kentucky	350,445	1,093,166	102,836	210,812	1,757,259	23,573	309,151	332,724
Louisiana	237,848	686,722	111,654	307,564	1,343,788	221,848	1,471,639	1,693,487
Maine	307,916	182,335	31,304	118,118	639,673	385	369,626	370,011
Maryland	1,378,780	898,527	142,181	537,183	2,956,671	26,381	3,844,497	3,870,878
Massachusetts	367,011	283,266	145,629	244,936	1,040,842	13,459	8,744,008	8,757,467
Michigan	367,889	188,637	114,947	213,904	885,377	10,215	1,255,716	1,265,931
Minnesota	87,736	21,762	94,021	126,551	330,070	12,787	1,761,187	1,773,974
Mississippi	312,429	379,785	89,776	234,067	1,016,057	73,868	1,160,690	1,234,558
Missouri	630,224	422,642	187,227	317,805	1,557,989	42,655	6,239,994	6,282,549
Montana	37,566	93,064	26,769	59,910	217,309	2,461	78,075	80,536
Nebraska	113,564	343,581	37,941	125,349	620,435	4,663	217,021	221,684
Nevada	54,035	226,732	19,641	226,554	526,962	36	230,112	230,148
New Hampshire	45,718	99,595	21,008	114,726	281,047	6,722	471,076	477,798
New Jersey	711,011	493,703	145,965	279,003	1,629,682	108,900	3,284,471	3,393,371
New Mexico	290,290	349,384	49,515	261,623	950,812	9,356	615,676	625,032
New York	543,499	749,795	229,372	361,520	1,884,187	5,377	6,546,787	6,552,164
North Carolina	414,439	2,258,954	116,264	671,972	3,461,629	2,414	1,101,328	1,103,742
North Dakota	51,171	224,602	25,501	26,402	327,676	1,299	120,515	121,814
Ohio	1,091,153	342,997	150,893	369,835	1,954,878	15,955	5,053,413	5,069,358
Oklahoma	651,866	696,112	120,537	337,319	1,815,834	17,706	641,409	659,115
Oregon	98,312	22,374	54,359	221,917	386,962	7,013	171,513	178,526
Pennsylvania	1,474,544	224,904	306,218	457,779	2,463,445	63,893	2,764,139	2,828,032
Rhode Island	138,917	147,628	32,271	76,878	395,694	1,130	415,354	417,484
South Carolina	595,656	1,316,068	168,103	526,418	2,606,245	22,585	545,581	568,166
South Dakota	36,369	145,977	23,540	40,741	246,627	1,759	65,667	67,426
Tennessee	190,774	201,973	108,973	397,090	898,374	30,197	1,088,248	1,118,445
Texas	1,849,868	3,258,588	319,561	2,036,072	7,264,089	126,464	9,136,350	9,262,814
Utah	632,384	135,528	98,639	108,005	974,556	13,846	958,799	982,645
Vermont	17,544	1,992	23,798	33,297	76,631	764	162,595	163,359
Virginia	3,479,351	4,154,703	184,847	1,560,075	9,378,976	37,773	5,858,975	5,896,749
Washington	879,416	1,293,047	131,083	725,181	3,028,727	46,395	2,904,660	2,951,055
West Virginia	48,764	9,694	33,283	88,868	180,605	37,775	125,665	163,440
Wisconsin	94,037	23,889	171,867	125,980	415,773	7,361	1,073,428	1,080,789
Wyoming	32,276	81,796	13,199	36,624	163,895	123	67,013	67,136
Total U.S.	27,959,767	38,220,511	5,821,458	20,590,933	92,592,669	1,365,357	118,551,260	119,916,607

Prepared by: Washington Headquarters Services Directorate for Information Operations and Reports

APPENDIX D

EXCERPTS FROM NEW YORK TAX LAW

§ 607. Meaning of terms

(a) General. Any term used in this article shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required but such meaning shall be subject to the exceptions or modifications prescribed in this article or by statute. Any reference in this article to the laws of the United States shall mean the provisions of the internal revenue code of nineteen hundred eighty-six [1] (unless a reference to the internal revenue code of nineteen hundred fifty-four is clearly intended), and amendments thereto, and other provisions of the laws of the United States relating to federal income taxes, as the same may be or become effective at any time or from time to time for the taxable year.

§ 687. Limitations on credit or refund

(a) General.—Claim for credit or refund of an overpayment of income tax shall be filed by the taxpayer within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed, within two years from the time the tax was paid. If the claim is filed within the three year period, the amount of the credit or refund shall not exceed the portion of the tax paid within the three years immediately preceding the filing of the claim plus the period of any extension of time for filing the return unless such claim is for a credit or a portion thereof pursuant to subsection (e) of section six hundred six of this chapter. If the claim is not filed within the three year period, but is filed within the two year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the two years

immediately preceding the filing of the claim unless such claim is for a credit or a portion thereof provided pursuant to subsection (e) of section six hundred six of this chapter. Except as otherwise provided in this section, if no claim is filed, the amount of a credit or refund shall not exceed the amount which would be allowable if a claim had ben filed on the date the credit or refund is allowed.

APPENDIX E

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

REPORT TO HOUSE OF DELEGATES

RECOMMENDATION

RESOLVED that the American Bar Association recommends to the state legislatures and municipal governing bodies of the United States that they adopt standards for state and local tax procedures that call for: (1) identical statutes of limitations for deficiencies and refunds; (2) identical interest rates for deficiencies and refunds; (3) no automatic imposition of penalties; (4) payment of disputed taxes only after the taxpayer is provided a hearing; (5) no seizure of property until after final adjudication; (6) a period of at least ninety days between the date of the deficiency notice and the date a notice of appeal is due; (7) the elimination of state fees to cover audit expenses; (8) providing taxpayers with due process; and (9) eliminating the need for taxpayers to relitigate identical legal issues in the same jurisdiction.

REPORT

For many years taxpayers have objected to perceived unfair and arbitrary treatment in compliance, assessment, and appeals of state and local taxes. When taxpayers perceive such treatment, voluntary compliance is seriously threatened. Addressing these concerns should increase respect for the tax system and improve the level of voluntary compliance.

Recent years have witnessed a significant increase in the amount of taxes raised at the state and local levels. For example, for the twelve months ended March 1989, state and local governments collected $488.1 billion—a 6.3 percent increase over the twelve month period that ended

March 1988. Increased tax revenues have resulted from tax increases (*e.g.*, rate increases, new taxes, broadening of existing tax bases) and enhanced enforcement of existing tax laws. The enhanced enforcement of state and local tax laws has increased the number of sensitive contacts between taxpayers and revenue collection agencies. The increase in contacts has heightened taxpayers' awareness of tax collection procedures. All of this has focussed discussion on the need for state tax policy makers and legislatures to give serious consideration to the procedural rights of taxpayers.

Consideration has led to very different responses. Some states have adopted procedural reforms through legislation while some states have done so through policy pronouncements from the revenue agency within the executive branch that is charged with implementing the tax laws. Further, some states have created a taxpayer advocate office, similar to the consumer advocate offices created during the 1960s and 1970s. Other differences are the ability to record interviews with auditors and the ability to sue the states. A comparison of all the laws that have passed is beyond the scope of this Report.

In September of 1988, California became the first state to adopt a taxpayers' bill of rights. California's legislation preceded the federal taxpayers' bill of rights. Subsequent to California's adoption, Arkansas, Illinois, Indiana, Kansas, Ohio, Oregon, and South Carolina also adopted taxpayer's bill of rights through legislation. Hawaii, Maryland, New York (state and city) and Texas adopted procedural reforms through policy pronouncements.

Over the years model legislation has been recommended that addressed procedural, due process and policy considerations in the state and local tax area. In addition to these model acts endorsed by the ABA, it is appropriate to enumerate broad principles to guide state tax policy makers and legislatures.

A review of the procedural reforms adopted by thirteen states reveals that none of the thirteen states have adopted all of the principles recommended.

Specific statutory language is not recommended because it is viewed that: (i) it is almost impossible to draft language to amend or replace existing language that is in many instances scattered throughout the statutory framework of the various states; (ii) some states have already enacted certain of the recommended principles into their statutes and would find statutory language covering additional principles difficult to use; (iii) informal discussions with officials from various states and with national tax organizations reveal that they do not think that statutory language would be desirable in this circumstance; and, (iv) it would be desirable to affect the procedural tax reform process that is currently sweeping the states in a timely fashion.

PRINCIPLES

1. *Statutes of Limitations—Other than Fraud*

   State and local statutes of limitations for assessments, in cases other than those involving fraud, should be the same for deficiency assessments and refunds.

   Federal audit adjustments should open state and local income tax periods which are otherwise closed by statute only for those issues raised in the federal audit.

2. *Interest Rates*

   Interest rates for deficiencies and refunds should be the same. Interest is payment for the time value of money. It should not be imposed at a rate that punishes a taxpayer for failure to pay taxes timely. State and local efforts to encourage timely payment of taxes and to punish non-compliance should be addressed by penalties and/or civil or criminal sanctions.

3. *Penalties*

   There should be no automatic imposition of penalties. Reasons for proposed penalties should be provided to the taxpayer by the taxing agency. The taxpayer should be given an opportunity to appeal, and penalties should be abated upon a showing by the taxpayer of reasonable cause. Penalties should not be enacted by legislatures to raise revenue—they should be designed solely to encourage compliance.

4. *Payment After Hearing*

   Taxpayers should not be required to post a bond or make a payment of a disputed tax until they have been afforded an opportunity for a hearing.

5. *Seizure of Property*

   A state or municipality should only be able to seize a taxpayer's property or levy against a taxpayer's assets after a final adjudication of the disputed amount or as a result of a jeopardy assessment where the probability of payment would be substantially reduced by the passage of time.

6. *Appeal Period*

   Taxpayers should not have to file a notice of appeal until at least ninety days have passed from the date on the notice of assessment. A reasonable period thereafter should be allowed for adequate preparation before a hearing is held and an opportunity should exist for the taxpayer to amend an appeal.

7. *Fees*

   Taxpayers should not have to pay the state or local government a fee for its expenses in auditing the taxpayers. Taxpayers should not have to pay the state or local government's court costs or litigation fees if a taxpayer prevails in a dispute.

8. *Due Process*

Taxpayers should be afforded both an opportunity for a hearing before an independent tribunal and receive an appealable decision therefrom. Taxpayers should also have the opportunity to be represented by counsel and afforded other standards of due process like the use of discovery.

9. *Application of Decisions*

Once the highest court in a jurisdiction rules on a particular legal issue taxpayers should not have to relitigate the identical issue in the same jurisdiction.

COMMENTS ON PRINCIPLES

1. *Statutes of Limitation—Other than Fraud*

The underlying premise supporting civil statutes of limitation is that there is a period beyond which establishing the factual characteristics of a case becomes burdensome, difficult or impractical. This is, likewise, true with regard to issues arising under state and local tax laws.

Several states have statutes of limitation that allow the state and local government a longer period to assess a tax deficiency than the taxpayer has to claim a refund. This is perceived as creating an inequity, particularly when the taxpayer has not committed fraud.

In the area of taxation, the facts needed to establish the taxpayer's correct liability are generally reflected in the taxpayer's books and records. In many instances, taxpayers maintain books and records solely for the purposes of being able to substantiate prior tax positions. Determining the period of time during which taxpayers should be required to maintain books and records is a subjective matter best left to the judgment of the legislature. However, once a tax-

payer has been asked to maintain books and records and to continue being exposed to potential increases related to past tax periods, it seems only fair to require that the government also expose itself to the risk of having to refund taxes erroneously paid for a like period.

Because many states and local jurisdictions use federal taxable income or federal adjusted gross income as a starting point in determining state income or franchise taxes, a federal audit adjustment may trigger the need to file an amended state or local income tax return. Often, the federal audit adjustment is made after the statute of limitation has expired for auditing the state or local income tax return. When this occurs, the federal audit adjustment should not be used by the state or local government as an excuse to audit the taxpayer's state or local income tax return for issues other than those raised in a federal audit.

2. *Interest Rates*

Consistent with the treatment of interest applied to federal income tax deficiencies and refunds, some states and local governments apply a higher interest rate to deficiencies than they pay when taxes are refunded.

This appears to be an unjustifiable position if one accepts the premise that interest should be the payment for the time value of money. Interest should not be used to punish a taxpayer for the over- or underpayment of taxes—this is best done through penalties and other civil/criminal sanctions.

Some commentators have advanced the argument that higher interest rates are justified for deficiencies than for refunds because the state takes a credit risk with respect to the taxpayer's ability to pay the deficiency

whereas the taxpayer presumably bears a smaller risk. Some taxpayers, however, are excellent credit risks, on apar with governmental bodies. It is inequitable to apply a higher interest rate to all taxpayers with deficiencies because a few are poor credit risks. If there is a question about a taxpayer's ability to pay a deficiency, seizure of property remedies are available. See comment on seizure of property, below.

3. *Penalties*

In recent years, the imposition of penalties has begun to be used as a revenue raising technique. Many tax jurisdictions automatically add penalty assessments to virtually all tax deficiencies. This is inappropriate if a taxpayer is neither notified of the reasons for the proposed penalties nor provided an opportunity to appeal such penalties. At a minimum, the tax agency should be required to have some basis for the penalty imposition. Further, penalties should be abated upon a showing of a reasonable cause.

4. *Payment After Hearing*

In many instances, taxpayers are required to post a bond or make payment of disputed taxes before being afforded an opportunity for an administrative appeal. This is inconsistent with federal income tax procedure and may often impose a severe hardship on taxpayers, especially when taxes erroneously collected from taxpayers are later refunded at below market interest rates.

5. *Seizure of Property*

Many state and local tax authorities abuse their power to seize property by exercising this power much too frequently. This power should be utilized only after a final adjudication of the disputed amount or in instances where a designated governmental official de-

termines that the probability of payment (*i.e.*, the collection for a deficiency) would be substantially reduced by the passage of time. The standards utilized to determine whether a jeopardy assessment is appropriate should be similar to those adopted by the federal government for purposes of the collection of federal taxes. Treasury Regulation 1.6851-1(1) (a) sets forth three conditions where a collection is in jeopardy; (i) the taxpayer is or appears to be "designing quickly" to leave the United States or go into hiding; (ii) the taxpayer is or appears to be "designing quickly" to place taxpayer's assets outside the reach of the government by removing, concealing, dissipating or transferring the assets; or, (iii) the taxpayer's financial solvency is or appears to be imperiled.

6. *Appeal Period*

A taxpayer's ability to appeal a tax assessment is basic to providing the taxpayer with due process. The regular delays encountered with mailing assessment notices and the amount of time necessary to evaluate such notices and determining whether an appeal is appropriate require that taxpayers be provided at least ninety days from the date on the assessment notice to file a notice of appeal. Shorter appeal periods often effectively eliminate any opportunity for due process.

As a related matter, once a notice of appeal is filed, taxpayers should be given time to amend such notice in order to perfect the appeal. Otherwise, a requirement that the taxpayer set forth his entire case may in some instances deprive taxpayers of the opportunity to analyze thoroughly the notice of assessment in conjunction with the taxpayer's books and records and other relevant information.

7. *Fees*

Some jurisdictions impose fees on taxpayers for expenses incurred in auditing the taxpayer and for legal costs incurred in defending tax appeals. While user fees may be an appropriate way of funding government services, it is unreasonable to charge taxpayers for the state's audit costs and it is also unreasonable to charge court costs if the taxpayer prevails in a dispute.

8. *Due Process*

Minimum standards of due process should be afforded a taxpayer when a tax is in dispute. Those standards include: (i) the opportunity to appeal an assessment before an independent tribunal; (ii) the opportunity to receive a decision from the independent tribunal which decision can then be appealed to a court; (iii) representation by counsel; (iv) the ability to call witnesses including government witnesses; and, (v) the availability of discovery to all parties.

It is believed that if the first level administrative appeal is provided by a part of an agency that has revenue collection responsibilities, then a de novo appeal should be provided to the taxpayer. In at least one jurisdiction (New York State) the revenue collection agency (*i.e.*, the Department of Taxation and Finance) cannot appeal unfavorable decisions from the Tax Appeals Tribunal to the courts. The concern is that this may have a chilling effect on the willingness of the tax tribunal to rule in favor of the taxpayer on the theory that the taxpayer can always appeal to the courts.

The burden of proof should generally be on the taxpayer, but, irrespective of who bears the burden of proof, the burden should ordinarily be met by a preponderance of the evidence.

9. *Application of Decisions*

State and local governments should establish procedures for implementing judicial resolutions of legal issues. Once the tax authority has lost a legal issue against a taxpayer, before the highest court in the state, there should exist some mechanism for ensuring that similarly situated taxpayers will not be faced with the litigation of legal issues that have already been resolved.

10. *Prospectivity*

There is a strong reluctance on the part of state and local governments to grant tax refunds when a tax has been held to be illegal or unconstitutional. Sometimes, there is a reluctance to refund taxes to the taxpayer litigant, and other times there is a reluctance to refund taxes to all similarly situated taxpayers unless those taxpayers have filed protective refund claims and/or lawsuits. The reluctance to grant refunds provides taxpayers with a disincentive to contest taxes and may serve to erode confidence in a voluntary system of tax compliance.

The issue of whether federal law requires state and local governments to provide taxpayers with retroactive relief when taxes have been exacted in violation of the commerce clause is before the U.S. Supreme Court in th case of *McKesson Corporation v. State of Florida* (October 1989 Term). While the tax authorities' reluctance to part with taxes that have been spent is understandable, the government's should either be prepared to refund taxes or they should escrow disputed taxes. However, no position is being taken on this issue, at this time, pending a review of the forthcoming Supreme Court decision.

Respectfully submitted,

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APPENDIX F

EXCERPTS FROM THE VIRGINIA INCOME TAX LAW AND REGULATIONS

Sec. 58.1-301. Conformity of terms to Internal Revenue Code.—A. Any term used in this chapter shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required.

B. Any reference in this chapter to the laws of the United States relating to federal income taxes shall mean the provisions of the Internal Revenue Code of 1954, and amendments thereto, and other provisions of the laws of the United States relating to federal income taxes, as the same may be or become effective at any time or from time to time.

Sec. 58.1-322. Virginia taxable income of residents.—A. The Virginia taxable income of a resident individual means his federal adjusted gross income for the taxable year, which excludes combat pay for certain members of the Armed Forces of the United States as provided in § 112 of the Internal Revenue Code, as amended, and with the modifications specified in this section.

Sec. 58.1-1823. Reassessment and refund upon filing of amended return.—A. Any person filing a tax return required for any tax administered by the Department of Taxation may, within three years from the last day prescribed by law for the timely filing of the return, or within sixty days from the final determination of any change or correction in the liability of the taxpayer for any federal tax upon which the state tax is based, whichever is later, file an amended return with the Department. If the Department is satisfied, by evidence submitted to it or otherwise, that the tax assessed and paid upon the original return exceeds the proper amount, the Department may reassess the taxpayer and order that any

amount excessively paid be refunded to him. The Department may reduce such refund by the amount of any taxes penalties and interest which are due for the period covered by the amended return, or any past-due taxes, penalties and interest which have been assessed within the appropriate period of limitations. Any order of the Department denying such reassessment and refund, or the failure of the Department to act thereon within three months shall, as to matters first raised by the amended return, be deemed as assessment for the purpose of enabling the taxpayer to pursue the remedies allowed under this chapter.

Sec. 58.1-1824. Protective claim for refund.—Any person who has paid an assessment of taxes administered by the Department of Taxation may preserve his judicial remedies by filing a claim for refund with the Tax Commissioner on forms prescribed by the Department within three years of the date such tax was assessed. Such taxpayer may, at any time before the end of one year after the date of the Tax Commissioner's decision on such claim, seek redress from the circuit court under § 58.1-1825. The Tax Commissioner may decide such claim on the merits in the manner provided in § 58.1-1822 for appeals under § 58.1-1821, or may, in his discretion, hold such claim without decision pending the conclusion of litigation affecting such claim. The fact that such claim is pending shall not be a bar to any other action under this chapter.

Reg. Sec. 630-2-499. Individual refunds; crediting overpayment against estimated tax.

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D. Statute of Limitations. No refund of any overpayment shall be made except upon discovery by the department or written application of the taxpayer within three years of the due date of the return for such taxable year or within sixty days from the final determination of any change or correction in the taxpayer's liability for federal income tax, whichever is later.